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IN THE

Supreme Court of the United States

October Term, 1937

No. 287

EDWARD MCLOUGHLIN,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE PETITIONER

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BRIEF FOR THE PETITIONER.

Opinions Below.

The opinion of the Circuit Court of Appeals is reported in 89 F. (2d) 699. The opinion of the Board of Tax Appeals is reported in 34 B. T. A. 963.

Jurisdiction.

The judgment of the Court below was entered May 3, 1937. Petition for certiorari was filed August 5, 1937, and granted October 11, 1937. The jurisdiction of this Court is conferred by Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

Constitutional Question Presented.

Is petitioner's 1932 salary for his services as an employee of the New York State Insurance Department subject to Federal Income Tax under the Revenue Act of 1932 in view of the implied constitutional immunity from tax of the compensation of State employees?

Statute and Regulations Involved.

Revenue Act of 1932 c. 209, 47 Stat. 169:

> Sec. 22. Gross Income.
>
> (2) *General Definition.*—"Gross Income" includes gains, profits, and income derived from salaries, wages, of compensation for personal service, of whatever kind and in whatever form paid, * * *."

Art. 643 of Treasury Regulation 77:

> "*Compensation of State officers and employees.*—Compensation paid to its officers and employees by a State or political subdivision thereof for services rendered in connection with the exercise of an essential governmental function of the State or political subdivision, including fees received by notaries public commissioned by States, is not taxable. Compensation received for services rendered to a State or political subdivision thereof is included in gross income unless (a) the person receives such compensation as an officer or employee of a State or political subdivision, and (b) the services are rendered in connection with the exercise of an essential governmental function. The commissions of receivers appointed by State courts are taxable. * * *"

Statement of Case.

The issue here presented involves the familiar question as to the right of the Federal Government to tax a state employee. The facts were stipulated and are set forth in full in the record (R. 6-11).

Petitioner was employed during the taxable year (1932) as a member of the legal staff of the Insurance Department of New York State (R. 6). He was employed by the Superintendent of Insurance pursuant to Section 63(6) of the New York Insurance Law, which authorized the Superintendent "to employ such counsel, clerks and assistants as may by him be deemed necessary, and give each of such persons such powers to assist him as he may consider wise". The present statute, Article XI, Section 414(1) of the Insurance Law (effective March 15, 1932) is to the same effect. Counsel for respondent conceded on argument in the Court below that petitioner was a state employee, so this brief will be confined to the remaining issues involved.

Petitioner's services were performed in behalf of a subdivision of the Insurance Department, which at the beginning of the year 1932 was known as the Liquidation Bureau (R. 6). The expression "Liquidation Bureau" has no statutory significance, being merely a convenient description used to designate those employees of the Insurance Department who as a group were engaged in carrying out the liquidating function of Superintendent of Insurance. The Liquidation Bureau was created in 1909 (R. 7) and its work consists of adjudicating claims, marshalling and liquidating the assets of dissolved companies (R. 8). When an order is obtained directing the liquidation of an insurance company its charter is dissolved and no new business is transacted (R. 8). Petitioner devoted 90% of his time during the year

in question to legal problems and cases involving the companies in liquidation, whose affairs were administered at the 80 Center Street Office of the Insurance Department, maintained in the State Building, New York City (R. 9). The balance of his time was devoted to the problems of the Bureau as a whole, such as the drafting of new Article XI, of the Insurance Law (R. 9).

In the statute authorizing petitioner's employment the method of providing funds for his compensation, as well as for the other persons employed to assist the Superintendent in the work of liquidation, was provided for as follows:

> "The compensation of such special deputy Superintendents, counsel, clerks and assistants, and all expenses of taking possession of and conducting the business of liquidating any such corporation shall be fixed by the superintendent, subject to the approval of the court, and shall, on certificate of the superintendent, be paid out of the funds or assets of such corporation." Sec. 63 (6) N. Y. Insurance Law.

New Article XI, Section 414(2) (effective March 15, 1932) *is to the same effect. This provision of the statute declaring* petitioner's salary payable out of the assets of the companies in liquidation appears to be clearly the reason for the ruling of the Commissioner of Internal Revenue that his salary was taxable and also for the decisions of the Board and the C. C. A. affirming petitioner's deficiency. As will be developed *infra*, it appears that this element as to the source of petitioner's compensation is a novel aspect of the constitutional principle of immunity from tax that is presented for the first time to this Court.

Summary of Argument.

The index of this brief embodies a summary of the argument presented on behalf of the petitioner.

I.

Petitioner is immune from Federal tax, being a State employee engaged in the administration of the New York Statute governing the liquidation of insurance companies.

The doctrine of implied constitutional immunity from tax, inuring to the Federal Government as against the states and to the states against the Federal Government, has been applied in a long line of cases ever since the foundation of the principle in *McCulloch* v. *Maryland* (1819) 4 Wheat. 316. A review of the many decisions of this court and the lower Federal courts show, while it has been impossible to formulate any all inclusive rule, that nevertheless certain principles can be deduced in respect to the taxation of Federal or State employees. A state may not tax an officer of the Federal Government (*Dobbins* v. *The Commissioners* (1842) 16 Peters 435) and the immunity is reciprocal in favor of a state officer (*The Collector* v. *Day* (1870) 11 Wall 113). The Federal Government however, has the power to tax an enterprise of a business nature even though carried on by the State, because under such circumstances the State is not exercising a governmental but rather a proprietary function (*South Carolina* v. *U. S.* (1905), 199 U. S. 437). When a State is thus carrying on a proprietary enterprise the salaries of those conducting it are not exempt from tax

(*Helvering* v. *Powers* (1934) 293 U. S. 214). If the nature of the enterprise however is truly *Governmental* (whether styled usual or essential) immunity exists and is absolute. *Indian Motocycle Co.* v. *U. S.* (1931) 283 U. S. 570 at 575; *Trinity Farm Co.* v. *Grosjean* (1934) 291 U. S. 466 at p. 471. The opinion of this court in *Brush* v. *Commissioner* (1936) 300 U. S. 352, refuted the idea set forth in the reversed C. C. A. decision (85 F. (2d) 32) that the function had to be literally *traditional* or *exclusively* within the *power* of a state to conduct in order to be immune.

It is unnecessary to give citations to establish the fact that in the long line of cases considered by this court, inquiry has been confined (when a tax on bona fide state employees was concerned) to the *nature* of the state activity involved. If both state employment and the proper Governmental function have been found to exist, this court has upheld the principle of immunity.* Neither the decision of the Board or that of the Court below took issue with the contention that petitioner was engaged in a proper Governmental function from the viewpoint of tax immunity although the point was argued at length in the briefs submitted in petitioner's behalf. The Court below stated it was "unnecessary" to deal with this question (p. 701). Respondent expressly recognized the proper Governmental function of employees of the bureau when holding their salaries non-taxable in his ruling of October 18, 1933, reading as follows:

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* Cases involving independent contractors such as *Metcalf & Eddy* v. *Mitchell* (1926) 269 U. S. 514, and taxes *indirectly* affecting the exercise of a State or Federal function such as *Willcuts* v. *Bunn* (1931) 282 U. S. 216, involve another aspect of this question and do not control where "state employee" relationship exists.

"Mr. Richard A. Brennan,
Special Deputy Superintendent,
State of New York Insurance Department,
80 Centre Street,
New York, New York.

Sir:

Reference is made to the letter addressed to you under date of November 3, 1932, in regard to the taxable status, for Federal income tax purposes, of the compensation received by employees of the *Liquidation Bureau of the New York State Insurance Department*, hereinafter referred to as the Liquidation Bureau.

In that letter it was held that the compensation of such employees was subject to Federal income tax, as the activities of the liquidation Bureau fell within the class of proprietary activities as distinguished from activities which are essentially governmental in nature. That ruling has been reconsidered by this office. Upon reconsideration it has been held that as the general supervision of insurance companies by a state constitutes the discharge of an essential governmental function and as the taking over of insolvent insurance companies for operation and liquidation by the state in accordance with the provisions of the state statute apparently constitutes an integral part of such supervision, the liquidation of insurance companies by the Liquidation Bureau constitutes the discharge of an essential governmental function. Accordingly the compensation of those individuals who are regularly and continuously employed by the Liquidation Bureau (as distinguished from those who are engaged to perform a particular service, such as the service which might be performed by a practicing attorney who is called upon by the Liquidation Bureau to render legal services for it in connection with the accomplishment of a specific object), that is the bonafide employees of the liquidation Bureau, *is exempt from Federal income tax.* The ruling of

November 3, 1932 is modified in so far as inconsistent herewith.

Respectfully,

GUY T. HELVERING,
Commissioner."

This ruling was subsequently revoked by the ruling of February 13, 1935 on the ground however that the compensation was paid from the assets of the companies and not because of the nature of the Bureau's function.

"Mr. Richard A. Brennan,
Special Deputy Superintendent,
State of New York Insurance Department,
80 Centre Street,
New York, New York.

Sir:

Further reference is made to the rulings rendered on November 3, 1932, and October 18, 1933, respecting the taxable status, for the purposes of the Federal income tax, of the compensation received by employees of the Liquidation Bureau of the New York State Insurance Department.

In the letter of October 18, 1933, it was held, after reconsideration of the question at issue, that as the general supervision of insurance companies by a state constitutes the discharge of an essential governmental function and as the taking over of an insolvent insurance company for operation and liquidation by the state in accordance with the provisions of the state statute apparently constitutes an integral part of such supervision, the liquidation of insurance companies by the Liquidation Bureau constitutes the discharge of an essential governmental function. It was further held that the compensation of those individuals who are regularly and continuously employed by the Liquidation Bureau (as distinguished from those who are engaged to perform particular ser-

vices, such as the service which might be performed by a practicing attorney who is called upon by the Liquidation Bureau to render legal services for it in connection with the accomplishment of a specific object) that is, the bona fide employees of the Liquidation Bureau, was exempt from the Federal income tax. The ruling of November 3, 1932, was modified accordingly.

Upon consideration of a similar question presented in the case of a bank liquidator, it was held (G. C. M. 13488, published in I. R. B. XIII-35, page 9) that where liquidators are engaged to render services in connection with the liquidation of a bank by the Banking Department of the State of Florida *and their compensation is paid from funds or assets of the bank being liquidated,* such compensation must be included in gross income for Federal income taxation as to subject it to the Federal income tax will not so burden the state as to constitute an interference by the Federal government, through taxation, with the discharge of an essential governmental function by the state. Because of the similarity of the functions of a liquidator to those of a receiver, your attention is directed to the decision rendered in the cases of Wright v. Commissioner, 29 B. T. A. 1267 and Abbott v. Commissioner, 30 B. T. A. 227. To subject the compensation received by liquidators of insurance companies to the Feleral income tax would not so burden the state or political subdivision as to constitute an interference by the Federal government, through taxation, with the discharge of an essential governmental function of the state or political subdivision.

It is apparent that the case under discussion is similar to the ruling contained in G. C. M. 13488, supra. Accordingly, it must be held that compensation received by employees of the Liquidation Bureau of the New York State Insurance Department constitutes income subject to the Federal income tax.

The ruling of October 18, 1933, is accordingly modified insofar as inconsistent herewith.

Respectfully,

GUY T. HELVERING,
Commissioner.

RLB/IM-I"
(Italics ours.)

Under such circumstances counsel for petitioner feel justified in only commenting briefly on the Governmental function element before considering what we consider to be the vital point involved, viz., the source of petitioner's compensation.

A state under its police power has the exclusive control and regulation of insurance companies.

From the earliest days the great public interest involved in insurance has necessitated Governmental supervision in some form. The history of Governmental regulation in Europe, England and this country is discussed in The Insurance Commissioner in the United States, Patterson (1927) pages 513-537. This court has repeatedly held that the insurance business is one which a state may regulate in the interest of the public under its police power,* and that a state may regulate a business for the protection of the public although the nature of the business itself is not governmental (*Ambrosini* v. *United States* (1902) 187 U. S. 1). It is also firmly established that the police power continues throughout liquidation (See *Matter of Bond & Mortgage Guarantee Company*, N. Y. Supreme Court (1935) 157 Misc.

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* *Merchants Mutual Auto Co.* v. *Smart*, 267 U. S. 126 (1925); *N. Y. Title & Mortgage Co.* v. *Tarver*, 51 F. (2d) 584 (1931); aff'd 285 U. S. 524; *O'Gorman and Young, Inc.* v. *Hartford Fire Ins. Co.*, 282 U. S. 251 (1931); *LaTourette* v. *McMaster*, 248 U. S. 465 (1919); *German Alliance Ins. Co.* v. *Hale*, 219 U. S. 307 (1911).

240 at 242). Compare *In re Union Guarantee & Mortgage Company* (1935) C. C. A. 2, 75 F. (2d) 984, (cert. denied 56 S. C. 142), opinion of the C. C. A. at page 984:

> "The most natural inference is that Congress meant to leave to local winding up statutes the liquidation of such companies; that, since the states commonly kept supervision over them during their lives, it was reasonable that they should take charge on their demise."[1]

This same principle has also been affirmed by the state courts. See *Mitchell* v. *Taylor* (Supreme Court California 1935) 3 Cal. 2nd 217) where the court discussed the function of the insurance commissioner of California while acting as liquidator.

> "There can be no doubt that the statute was enacted under the police power for a purpose connected with the public interest; that the legislature has declared the liquidation of insolvent insurance companies a matter in which the state has an interest; and that consequently it has made provision for a state officer to protect and advance that interest. The Insurance Commissioner is not a mere private trustee, or receiver wholly dependent on the appointing court for his powers. He is a state officer, performing duties enjoined upon him by statute, and in their performance he acts on behalf of the state" (p. 219).[2]

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[1] Compare *Hopkins Savings Assn.* v. *Cleary* (1935) 296 U. S. 315, 337, as to exclusive state control over building and loan associations and *Chicago Title & Trust Company* v. *Forty-One Thirty-Six Wilcox Building Corporation* (October Term, 1937), (Nos. 23, 24, U. S. where this Court stated "How long and upon what terms a state-created corporation may continue to exist is a matter exclusively of state power" (p. 4, stenographic copy of opinion).

[2] To the same effect see the following: *State* v. *Hall* (Supreme Court Mo. (1932) 52 S. W. (2d) 174; 330 Mo. 1107); *State* v. *Farm & Home Savings & Loan Assoc.* (Sup. Ct. Mo. 1936), 90 S. W. (2d) 93, 96; *People* v. *Niehaus* (Sup. Ct., Ill. 1934) 356 Ill. 104; 190 N. E. 349, 352; *O'Malley* v. *Hankins* (Sup. Ct., Ind., 1935) 194 N. E. 168; *Clark* v. *Williard* (1933), 292 U. S. 112, 120.

This court has recognized the governmental nature of the police power function. In its opinion in *Ohio* v. *Helvering* (1934) 292 U. S. 360, the following statement appears at page 369:

> "Nevertheless, the police power is and remains a governmental power, and applied to business activities is the power to regulate those activities, not to engage in carrying them on. * * * When a state enters the market place seeking customers it divests itself of its *quasi* sovereignty *pro tanto*, and takes on the character of a trader, so far, at least, as the taxing power of the federal government is concerned."

The fact that the charters are dissolved of all companies in liquidation (R. 8) necessarily eliminates the "seeking of customers". New York State has not undertaken to carry on the business of insurance, but merely has taken over liquidation to protect the great public interest involved.* The long line of cases that can be classified as involving "proprietary enterprises" conducted by a state are clearly distinguishable. These all involved the element (not present in our case) of *operation* of a *business* for profit in some form.

The great public interest in the insurance business first made necessary the supervision and regulation of insurers as going concerns and in the year 1909 the New York State Legislature determined it was necessary for the state to extend its supervisory powers to include the conduct of liquidation proceedings.

The statute under which the control of liquidation was given to the Insurance Department was enacted as a result of a message to the legislature by the present Chief Justice,

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* Compare G. C. M. 14952 (XIV-2 C. B. 130) holding the compensation of officers and employees of the state compensation insurance fund of California taxable on the ground that "The State is *not* limiting its activity to regulating the business but is engaged in carrying it on" (p. 134—Italics ours).

then Governor of the State of New York, under date of March 8, 1909. Governor Hughes' message in part stated as follows:

> "The serious delays and enormous waste connected with receiverships, both of banking and of insurance corporations, has directed attention to the advisability of providing suitable means for economical and speedy liquidation through the agency of the respective State departments. Last year the Banking Law was amended so as to provide for liquidation of banking corporations by a business-like method, and the wisdom of the provision has already been demonstrated by experience. Similar exigencies arise in connection with insurance corporations and should be dealt with in a similar way." (See Senate Documents 132nd Session, Vol. V, No. 26).

This power of the state to conduct liquidation has always existed, although not exercised until 1909. As this court stated in *Brush* v. *Commissioner, supra,* at page 371:

> "Governmental functions are not to be regarded as non-existent because they are held in abeyance, or because they lie dormant, for a time. If they be by their nature governmental, they are none the less so because the use of them has had a recent beginning."

The Superintendent of Insurance represents the State in liquidation proceedings.

At the head of the New York Insurance Department is the Superintendent of Insurance whose duty is to administer the insurance law. In *Matter of Casualty Co. of America* (Rubin Claim) (1927) 244 N. Y. 443, CARDOZO, *Ch. J.*, referred to the liquidating function of the Insurance Department and the Superintendent of Insurance in the following language (p. 447):

> "The liquidation of insurance companies in this State is governed by a statute adopted, in its main

features, in 1909. The system of liquidation by receivers specially appointed had proved to be dilatory and wasteful. The Legislature substituted administration by a department of the government. Upon the application of the Superintendent of Insurance, an order may be made by the Supreme Court for the liquidation of the business. The work is to be done by the Superintendent and his deputies, but under the supervision of the court, and subject to its direction. 'Such liquidation shall be made by and under the direction of such superintendent, and his successors in office, who may deal with the property and business of such corporation in their own names as superintendents, or in the name of the corporation, as the court may direct' (L. 1909, ch. 300, Sec. 63, subd. 3)."

Compare *Matter of Union Bank* (1912) 204 N. Y. 313, at 322 as to the status of the Superintendent of Banks.

This court in *Relfe* v. *Rundle* (1880), 103 U. S. 222, recognized the status of the Missouri State Superintendent of Insurance as that of a state officer when acting as Liquidator (p. 225).

> "He is an officer of the State, and as such represents the State in its SOVEREIGNTY while performing its public duties connected with the winding up of the affairs of one of its insolvent and dissolved corporations. His authority does not come from the decree of the court, but from the statute." (Capitals ours.)

Compare *Greenfield Savings Bank* v. *Commonwealth* (1912), 211 Mass. 207, in connection with the status of the Bank Commissioner of Massachusetts, also *in re Chetwood* (1896), 165 U. S. 443, where a receiver of a national bank appointed by the comptroller of the currency was said to be

"the agent and officer of the United States" (p. 458). Insofar as being engaged on a governmental function is concerned petitioner is in the same status as the Superintendent, being merely a statutory assistant performing legal services for the superintendent. (Compare *Therrell* v. *Commissioner* (1937), C. C. A. 5, 88 F. (2d) 869, 872.)

In New York the State alone can conduct liquidation through the Liquidation Bureau of the Insurance Department. Even solvent companies must be thus liquidated (*Reed* v. *Squire*, 1st Dept., A. D. 1926-217 A. D. 494, 497). It is respectfully submitted that petitioner was engaged in carrying out a governmental or sovereign function of the State, and that the immunity of his compensation from Federal income tax is *absolute* within the principle of the cases referred to.

II.

Petitioner's immunity from tax is not nullified because the New York statute provides that the assets of the companies in liquidation shall be used to pay his salary.

G. C. M. 13488 is a new and unsound ruling under which the element of the source of an employee's compensation is made a decisive test of immunity.

Prior to G. C. M. 13488 (XIII-2 C. B. 156) promulgated December, 1934, the Commissioner of Internal Revenue consistently ruled that the source of compensation was immaterial on the question of immunity from tax of the salaries of state employees. See the following:

O. D. 1053 (5 C. B. 106)—(Fees of deputy sheriffs);

I. T. 1316 (I-1 C. B. 105)—(Compensation of deputy bank examiners appointed by a state bank examiner and paid out of the assets of insolvent banks);

I. T. 1693 (II-1 C. B. 72)—(Fees of public administrators);

I. T. 2030 (III-1 C. B. 117)—(Fees of public administrator in Montana);

I. T. 2214 (IV-2 C. B. 46)—(Compensation of receiver of insolvent Kansas bank);

G. C. M. 60 (V-1 C. B. 45)—(Compensation of secretary of Kansas State Fair Board paid largely from fair earnings);

G. C. M. 11625 (XII-1 C. B. 69)—(Fees of special masters in chancery in Illinois);

I. T. 2710 (XII-2 C. B. 79)—(Employees of state banking depart. paid out of insolvent bank assets).

I. T. 1316 ruled as follows:

> "The compensation of the special deputies of course comes out of the assets of the bank or trust company, but the source of compensation is not important, for as was said in *Bettman* v. *Warwick* (108 Fed. 46), cited in Law Opinion 382, it is for the government which makes the appointment to determine how the compensation shall be paid."

The Treasury Regulations up to and including Art. 643, Reg. 77 (1932 Act) similarly did not limit the immunity of state officers and employees to situations where their compensation was paid directly by the state or a political subdivision thereof. There is nothing in Art. 643, Reg. 77, to preclude petitioner's immunity because his salary is not

raised by the usual method of taxation. The provisions of this regulation (insofar as relevant) are the same as the regulations promulgated in connection with the prior revenue acts, see Reg. 75 (1928 Act); Art. 88, Reg. 69 (1926 Act); Art. 88, Reg. 65 (1924 Act); Art. 88, Reg. 62 (1921 Act); Art. 85, Reg. 45 (1918 Act); Art. 5 (g), Reg. 33, (1917 Act). When we come to the latest regulation (Reg. 94, Art. 116-2) however, we find a changed attitude on the part of the Treasury, and the new regulation states that compensation is taxable unless received "from the State or political subdivision as an officer or employee thereof * * *".

It is pertinent to inquire into the history and basis for this changed attitude on the part of the Commissioner and the Treasury Department as expressed in the new regulation above referred to, which adds a completely new element to the principle of immunity from tax of state officers and employees.

The origin of this new theory as to the element of the source of compensation is to be found in G. C. M. 13488, *supra*. This ruling was clearly an attempt to graft a new element by way of limitation to the principle of immunity. The ruling involved the compensation of a "special" bank liquidator in Florida. It first states that the taxpayer was not a state officer and casts doubt on his employee status, comparing his relationship with the state to that of an independent contractor. After quoting at length from *Metcalf & Eddy* v. *Mitchell, supra*, the ruling states that even if the "special" bank liquidator were a state employee, nevertheless he was not exempt from tax, because

> "* * * it is certain that a tax upon his income cannot be deemed to be an interference with government, or an impairment of the efficiency of its agencies in any substantial way. No such interfer-

> ence could result with respect to this taxpayer since the compensation was not paid by the State, but by the bank which was being liquidated. * * *"

and concludes as follows:

> "In view of the decision of the Supreme Court in the *Metcalf & Eddy* case, it seems reasonably certain that that court will not extend the exemption to income which is not received from a State or political subdivision where the taxation of the income will in no way *burden* the state." (Italics ours.)

This ruling is clearly based on the thought that in order to spell out a "burden" resulting from income tax the *treasury* * of a state or political subdivision thereof must be affected.

The only case cited in the ruling on the source of compensation point is *Miller* v. *McCaughn*, C. C. A. 3 (1928) 27 F. (2d) 128 (affirming 22 F. (2d) 165). As this case will presumably be relied upon by counsel for the Commission it is in order to refer briefly to it. The cited case involved the taxability of an examiner or auditor appointed by a state court to report to it the financial standing of corporations applying to be approved as sureties on court bonds. The compensation was provided out of moneys deposited by the surety companies with the clerk of the court. The United States Circuit Court of Appeals for the Third Circuit affirmed the district court and held the compensation taxable. The court held that "in no sense can such examiner be regarded for income tax exemption as an officer or employee of the State of Pennsylvania", and in reaching this conclusion merely commented on the fact that the examiner received no pay from the State. As stated in

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* To same effect see opinion below of the C. C. A. at page 701.

the opinion of the court at page 128, the contention of the government was that the taxpayer did not come within the income exemption provision of an "officer or employee of state or political subdivision thereof". While G. C. M. 13488 quotes from the district court opinion in *Miller* v. *McCaughn* the real basis for the *upper* Court's decision was that the officer or employee relationship had not been established. The brief of the Commissioner on appeal did not even maintain that the source of compensation was material. The facts show the funds were *voluntarily* deposited by the surety companies and the true situation would appear to be that the *companies* employed the auditor who had merely been designated by the court to act in such capacity.

The cited case was analyzed by the Board of Tax Appeals in *David K. Cochrane, Petitioner* v. *Commissioner* (1932), 26 B. T. A. 1167 at 1171-1172:

> "We think that *Miller* v. *McCaughn*, supra, is not authority for the proposition that the source of the income of a state officer alone determines its taxability by the Federal government." (Citing and quoting *Bettman* v. *Warwick*, 102 Fed. 127; affirmed 108 Fed. 46.)
>
> "In many of the States the so-called fee system is widely employed as a means of providing compensation for State, county and municipal officers employed in the performance of duties clearly of a strictly governmental nature. The alternative of the fee system would necessarily require the payment of the compensation of these officers out of public funds."

A recent case shows conclusively that the Circuit Court of Appeals for the Third Circuit did not base its decision in *Miller* v. *McCaughn* on the source of compensation element.

(See *Freedman* v. *Commissioner* (1937), C. C. A. 3rd, 92 Fed. (2d) 150, referred to *infra,* page 21 of this brief).

After the promulgation of G. C. M. 13488 (based on the theory of the "independent contractor" doctrine) the Commissioner applied the ruling to situations where bona fide employees were concerned, such as in petitioner's case. The prior rulings were revoked and additional rulings were made applying the "source of compensation" idea expressed in G. C. M. 13488. (See G. C. M. 14116; XIV-1 C. B. 102 ruling taxable the compensation of a public administrator of a county in Massachusetts whose compensation was paid out of the assets of the estates administered; also G. C. M. 14957; XIV-2 C. B. 130 ruling taxable the fees received by notary publics in the State of Louisiana where the fees were paid by the individuals employing the notaries.) The present attitude of the Commissioner and the Treasury Department on this whole subject is now set forth Mim. 3838; XV-1 C. B. 130.

The vague expression in G. C. M. 13488 that exemption fails where compensation is paid out of the assets of a closed bank (or similarly an insurance company) because under such circumstances no "burden" is placed on the state, has since been adopted by the Board of Tax Appeals in various of its decisions, viz.: *Freedman* v. *Commissioner,* 34 B. T. A. 956 (reversed C. C. A. 3rd, *supra*). The same expression was seized upon by the Court below in affirming petitioner's deficiency and in fact constitutes the entire *ratio decidendi* of the opinion, viz.:

> "We think the justification for denying exemption in each category is that the tax imposes no real burden upon, or impediment to a normal exercise of sovereign power" (p. 702).

At page 703 the opinion concludes as follows:

> "But whatever may be said of some situations where compensation is not derived directly from the public treasury we are persuaded that a liquidating agent paid wholly out of the property of an insolvent is not entitled to exemption."

The theory of G. C. M. 13488 was rejected by the C. C. A. 5th in *Therrell v. Commissioner*, and by the C. C. A. 3d in *Freedman v. Commissioner*.

In *Therrell* v. *Commissioner, supra,* the court rejected the reasoning in the ruling and stated as follows, on the identical facts:*

> *"The liquidator cannot by the United States be taxed on his employment to any extent. If anything is taken from him as tax, he would lack that much of receiving what the state law allows him.* Compare *Dobbins* v. *Erie County,* 16 Pet. 435, 10 L. Ed. 1022, where the compensation of the captain of a United States revenue cutter was involved and *Hoskins* v. *Commissioner* (C. C. A.) 84 F. (2d) 627, where the salary of a superintendent of a state public school cafeteria was sought to be taxed. The tax assessed here cannot constitutionally be sustained" (p. 872). (Italics ours.)

The Board of Tax Appeals in deciding petitioner's case did so on the authority of its opinion simultaneously issued in *Freedman* v. *Commissioner* (34 B. T. A. 956), stating it was unnecessary to repeat its views as petitioner's case was in all material respects similar to the *Freedman* case. The decision of the Board in the *Freedman* case was reversed,

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* Different taxable years being the only difference.

however, by the Third Circuit. The court disposed of the source of compensation point as follows:

> "* * * the quantum of the employee's pay, *the means by which he is paid,* are features which do not on the other hand determine the liability of the national employee to state taxes or the state employee to Federal taxes * * *" (p. 152). (Italics ours.)

The quantum of interference to a State from Federal Income Tax on its employees and the source of their compensation is of no consequence.

Counsel submit that G. C. M. 13488, *supra* (as construed to apply to state employees), is unjustified by precedent and is based on a misconception of the very roots of the constitutional principle involved. The quantum of the interference of a sovereign state's activities resulting from a tax, is of importance only when testing the constitutionality of a tax on independent contractors (*Metcalf & Eddy* v. *Mitchell, supra*) or a tax *indirectly* connected with the exercise of a state function, viz. (*Willcuts* v. *Bunn, supra*)[1]. When the tax, however, is *directly* imposed on the exercise of a governmental function (such as a tax on an officer or employee), the amount of the tax in question, the justness of the tax, or the quantum of resulting interference to the state is of no consequence.[2] In the language of the court in *U. S.* v. *Railroad Company* (1872), 17 Wall 322,

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[1] The cases cited in the opinion of the C. C. A. below (p. 701) illustrating the alleged "burden" test all involve taxes with an indirect connection with a State function.

[2] The briefs submitted to this Court in behalf of the Commissioner in *Lucas* v. *Howard* (1929) 280 U. S. 256, and *Lucas* v. *Reed* (1930) 281 U. S. 699, conceded this principle. Brief in *Howard* case at pages 17 and 18. Brief in *Lucas* case at pages 22 and 23.

> "* * * the beginning of such taxation is not allowed on the one side, is not claimed on the other" (p. 328).

Again as stated in *Indian Motocycle Co.* v. *U. S. supra,* at page 575:

> "Where the principle applies it is not affected by the amount of the particular tax or the extent of the resulting interference, but is *absolute* * * * citations." (Italics ours.)

The Circuit Court of Appeals for the Second Circuit recognized the rule in *Commissioner* v. *Ten Eyck* (1935), 76 F. (2d) 515, 519,

> "Where immunity exists, it rests upon an entire absence of power to tax."

The case of *The Collector* v. *Day, supra,* was the first case which involved the constitutionality of an *income* tax in respect to a state officer. In holding the tax unconstitutional, the court did not consider the *weight* of any "burden" on the Treasury of the State of Massachusetts resulting from the income tax assessed against the state probate judge, but merely affirmed the principle implied in the previous cases that the Federal Government lacked power to tax, in any way, a state officer. The very statement that inquiry must be made as to the effect on a state's treasury of the imposition of Federal income tax on an employee would seem to demonstrate the fallacy of such theory. Income taxes are paid out of the pockets of the individual taxpayers and no part of the tax ever comes out of the treasury of a state or a political subdivision thereof.

The argument will presumably be made by counsel for the Commissioner that when a state officer or employee is

paid out of the state treasury, the inference is that if such officer had to pay a Federal income tax, the state would have to raise his salary and that consequently the state treasury in the last analysis would be depleted. Such reasoning has never been relied on by this court in the many cases holding income taxes unconstitutional on either Federal or State employees. The presumption is purely guess work and would constitute a tenuous basis for an important and far reaching principle of law. If the reason for the rule were based on any such presumption it would be equally applicable in the "independent contractor" cases illustrated by *Metcalf & Eddy* v. *Mitchell, supra, Lucas* v. *Reed, supra,* etc. If the presumption exists it would follow that an income tax on "independent contractors" would directly affect a state's treasury because of the necessity of paying additional compensation and the contractor's compensation would therefore be exempt. The existence of any such presumption, however, was impliedly denied by this court in reversing without opinion the Third Circuit in *Lucas* v. *Reed, supra,* in which the taxpayer in his brief to this court contended (at p. 14) that:

> "If it were ruled that a lawyer's compensation for services rendered in a matter of government and sovereignty is subject to a substantial Federal tax, it would doubtless be obliged to pay more for the lawyer's services than if his compensation were not subject to federal taxation. If the compensation of a state servant be subject to federal taxation, the effect is for the State itself to pay the tax."

The fee system is still used in many States to provide compensation for State officials or employees.

The theory for denial of immunity advanced by the commissioner and followed by the court below would create a wholly unwarranted distinction between state paid salaries and the fee system which latter still prevails in many states.

There are so many different methods of compensating state employees it would be beyond the scope of this brief to attempt to itemize the system used by one state, let alone the system followed by all the forty-eight states. New York state officers and employees, however, can be generally classified as follows:

(1) Officers and employees of the state itself.

(2) Officers and employees of a territorial subdivision, such as a county.

(3) Local officials employed by a city, village, town, etc.

(4) Those employed by a state corporate instrumentality such as the Bureau of Water Supply of the City of New York.

Generally speaking it may be said that the salaries of the officers of the state itself are fixed either in the state constitution or by statute and their salaries are paid out of general funds of the state raised through taxation. When we come to the next class, or those employed by a county or district, we usually find that while certain officials such as county judges and public administrators, are compensated by salaries which are county or district, etc., charges, the salaries of the remaining officials both as to amount and method of payment are determined by some county or district authority such as the Board of Supervisors in New

York (McKinney's Consolidated Laws of New York) (County Law, § 12 (5)). Similarly the local officials or employees of a town and village have their compensation provided for by local boards, such as the town boards in the State of New York. (See McKinney's Consolidated Laws of New York, Volume 61, Town Law, § 27.) This amendment effective January 1, 1934, substituted a salary system for the payment of town officers subject to the section.

From the earliest days the recognized representatives of the sovereign received their sole compensation from fees. One excellent illustration is that of the sheriff in early English history, who was entitled to specific sums for specific services. (See Murfree on Sheriffs' Second Edition (1890), § 1065.) The sheriff in New York County was formerly compensated by a salary plus one-half of fees (Laws 1890, Chapter 523, § 1, as amended by Laws 1913, Chapter 373, I D § 2), but now receives a straight salary under the present statute. (Chapter 558, New York Laws of 1919.) Public administrators in some states are still compensated on the fee basis such, as the Public Administrator in Erie County, New York (N. Y. C. P. A. §125), and there are innumerable other examples of minor officials such as county clerks, county treasurers, tax collectors,[1] justices of the peace, constables, district attorneys, recorders, marshalls, port wardens[2] who receive their compensation either in whole or in part from fees collected directly from the public who make use of their services.

In some states salaried officials are allowed to collect and retain fees in payment of their salaries, paying only the excess of the fixed salary into the treasury of the county or district, etc., as the case may be. In Maryland under Article

[1] See McKinney's Cons. Laws of N. Y., Vol. 59, Tax Law § 81.
[2] See Maine Revised Statutes 1930, Chapter 48, p. 774, § 13.

III, Sec. 45 of the State Constitution, the compensation of Clerks of Courts and Registers of Wills, while limited to a fixed sum, is nevertheless derived from fees (Ann. Code of Md. (Bagby) Vol. 1, at p. 101) and parties to a civil suit are directly liable to a clerk for costs, *M. & C. C. of Balto.* v. *Pattison* (1920) 136, Md. 64, 68.* See also Code of Iowa (1935) Title XXIX, Justices of the Peace, Chapter 475, § 10639, providing that fees in excess of specified sums to be paid into the county treasury. See also Jones, Illinois Statutes Annotated, Vol. 22, § 110.173, providing that fees in excess of the compensation allowed to probate clerks are paid into the county treasury. See also Burns, Indiana Statutes Annotated, Vol. 10, 1937 supp. § 49.1009, as to the fees of county recorders, providing that 20% of collections shall be retained by the recorder in each county, with added provision that the combination of salary and percentage of fees retained shall not exceed a fixed sum. In Texas *maximum* fees are prescribed instead of straight salaries for certain officials. (See Vernon's Texas Statutes, 1936, Title 61, Fees of Office, Article 383 and following.) In California the fees of county officers are paid into the county treasury and held in what is called a "salary fund" which is used to pay salaries. See Political Code, California, Chapter 10, Salaries & Fees of Officers, 1935 supp. Article LXI, § 4305:

> "For the purpose of paying salaries all fees directed to be paid into the county treasury shall be set apart therein as a separate fund, to be known as the salary fund, to be applied to the payment of salaries. Should, in the opinion of the auditor, the fees to be collected be not sufficient for such purpose, it shall become the duty of the board of supervisors at the time the tax levy is made to estimate such de-

* See Article XV, Section 1, of Md. Const. governing the payment of *excess* fees to the State Treasury.

ficiency and raise it by direct taxation the same as other bonds. The proceeds of the tax levied therefor shall be paid into said salary fund (Amendment affirmed, July 16, 1935, Stats. 1935, p. 1812)."

In Nevada the fees received by the clerk of the Supreme Court are paid into a treasury fund used to pay salaries of judges. See Compiled Laws of Nevada, 1929 (Hillyer), Volume 2, § 2965.

> "The clerk of the Supreme Court shall, on the 1st Monday of each quarter, pay to the State Treasury the moneys received by him for court fees, rendering to said treasurer a brief note of the cases in which the same were received. The money so received by the treasurer shall be placed in the supreme court judges salary fund, and the same shall be used for no other purpose" (Stat. 1919, Subdivision (15)).

The judges of the Court of Common Pleas, Oklahoma County, Okla., are paid out of a fund derived from fees. (Oklahoma Statutes Annot. Titles, 19-20, § 706.)

The imposition of Federal Income Tax on State employees necessarily restricts the power of a State to carry out its governmental functions.

Salaries and fees are the means by which a state obtains the services of its employees and constitute the inducement to enter its service. Any tax imposed by the Federal Government diminishing the net compensation of a state employee necessarily makes the inducement less attractive and directly interferes with or burdens the power of the state to procure employees and (if carried to an extreme) to function at all. The connection of a federal income tax with the ability of a state to function is thus not only direct but in

fact precedes the commencement of a state function by handicapping a state in employing servants in its behalf.

The first tax (1913 Act) consisted of a normal tax of 1% with surtax of 1% on incomes between $20,000 and $50,000. Under the present act the exemptions are less, the normal tax commences at 4%, and the increases in the normal tax and the high surtaxes are too well known to merit further detail. While a tax of 1% might not deter many persons from entering state service, taxes at the present or even higher rates would necessarily make it more difficult for a state to procure proper agents. It could hardly be contended that a tax of 50% was of no importance to prospective state employees and yet the same principle is involved.

The state courts recognize the interference of a state income tax when applied to a federal officer. The Supreme Court of North Carolina in *Purnell* v. *Paige* (1903), 133 N. C. 125) in holding exempt from state income tax the salary of a federal court judge stated as follows:

> "If the State could tax the salaries of Federal officers, or the Federal Government could tax the salaries of State officers, either could destroy the efficiency of the operations of the other government, since each government must act through its officers."

The true theory advanced and adhered to rigidly by our courts is that such income taxes, regardless of the amount of the same are unconstitutional because they interfere with the law of the sovereign (whether Federal or State) fixing the employees' compensation and in effect over-ride the will of the other sovereign, viz., one independent government cannot take away or reduce the compensation fixed by another sovereign state for the compensation of its agents (*Dobbins* v. *Commissioner, The Collector* v. *Day, supra*).

Compare *Evans* v. *Gore* (1919), 253 U. S. 245, and *Ashton* v. *Cameron County District* (1936), 298 U. S. 513 at 531; *Purnell* v. *Paige, supra* (p. 128).

The following court decisions involve officials who were not paid directly by the state or a political subdivision thereof and who were held exempt from Federal income tax:

Brush v. *Commissioner, supra*—(Revenue of City Water Works in part supplied from water charges);

N. Y. ex rel. Rogers v. *Graves, et al.* (1937), 299 U. S. 401—(Compensation of the taxpayer, general counsel for the Panama Railroad paid out of profits of Panama R. R. Co. See opinion N. Y. A. D. 3rd Department, 245 A. D. 452 at 454);

Hoskins v. *Commissioner* (1936), 84 Fed. (2d) 627, C. C. A. 5—(Salary paid out of receipts of cafeteria);

Therrell v. *Commissioner, supra*—(Compensation of bank liquidator paid out of assets of the banks);

Freedman v. *Commissioner, supra*—(Compensation paid out of bank assets);

Montgomery B. Case v. *Commissioner* (1936), 34 B. T. A. #187, Aff'd without opinion C. C. A. 2 under title of *Commissioner* v. *Gerhardt*, F. (2d). (New York Law Journal, Nov. 4, 1937) —(Compensation of officers and employees of Port of New York Authority paid out of a fund derived from tolls and fees collected from the public);

Bettman v. *Warwick* (1901), C. C. A. 6, 108 Fed. 46—(Compensation paid by private individuals employing services of a notary public).

The principle of *The Collector* v. *Day, supra,* though distinguished many times either on the "independent contractor" or "non-governmental function" phase has never been departed from by this court. The decision of the Second Circuit below is the only one of which counsel are aware, where the source of compensation element was held to be the *decisive* element for denial of immunity.

If the power to tax the incomes of state officers and employees exists, it follows incontrovertibly that their compensation can be reduced to the vanishing point and the ability of a state to function thus destroyed (compare *Veazie Bank* v. *Fenno* (1869) 8 Wall 533, 549).

The payment of petitioner's compensation by the statutory appropriation of the assets of the companies in liquidation is in substance the same as a special property tax.

When an insurance company has once been placed in liquidation, the control of its affairs is taken away completely from the officers, directors and stockholders. The Superintendent, pursuant to the statute, is authorized to appropriate money out of the assets in order to pay the expenses of administration including petitioner's salary. The use of these funds must necessarily be pursuant to the state's police power because the consent of the stockholders, who own the corporation is not obtained. If the system is considered in its true light, there would seem to be no distinction between such a levy and a levy in the nature of a special tax that might be easily incorporated in the tax law. See *Therrell* v. *Commissioner, supra,* at page 871:

> "He (the bank liquidator involved) is not chosen by the bank or its creditors, but over their heads. *It is superficial to say that they pay him.* The State

> by its officer does that out of the bank's money, not by the consent of the bank or its creditors but by the State's power, an exaction not unlike the levying of a tax for the purpose." (Italics ours.)

The situation is little different from special assessments on property owners imposed by the state without the consent of such owners with the object of making improvements, constructing a new street, etc. The weakness in the ruling of the Commissioner that the source of compensation *alone* determines immunity is apparent from the fact that it would be possible for the state to pay the employees of the Liquidation Bureau out of state funds in the first instance and then proceed to tax the companies in liquidation under the same formula now adopted in assessing such charges directly against the assets of the companies in liquidation. If the exemption from tax depends upon the Commissioner's theory (upheld by the court below), the exemption would stand or fall, depending upon the particular form of bookkeeping decreed by the statute establishing the liquidating function of the Superintendent and his statutory assistants. (See Political Code Cal. 1935 Supp., *supra*, Nevada Statute, *supra*.)

III.

If the basis for the immunity of State employees from Federal Income Tax be considered to be the presumption that taxation would result in increased salaries then under the same presumption an increase of petitioner's salary would impede and interfere with the State function of effecting economical liquidation of insurers.

As previously set forth (p. 24), counsel do not understand that the exemption from Federal income tax is based on the *presumption* that the imposition of the tax would require increased salaries with resultant depletion of a state's treasury. If, however, such a conception be considered by this court to be the basic reason for immunity from income tax, then a similar presumption as to increase in salary would necessarily apply in petitioner's case. From such point of view an increase in his salary would deplete the assets of the companies in liquidation. The primary purpose of state controlled liquidation is recognized to be economy in the administration of the assets subject to the claims of the interested public (*Matter of Casualty Company of Am., supra; Matter of Knickerbocker Life Ins. Co.*, 1st Dept. N. Y. A. D. 1922, 199 A. D. 503). If the presumption applies, the tax directly operates against and obstructs such economy of administration and imposes a direct burden on the attempt of the state to achieve its purpose. The immunity of a state from federal interference is not confined to interference with its fiscal affairs *per se*, but is a broader protection from any *form* of interference with state sovereignty. (Compare *Ashton* v. *Cameron County*

Dist. (1936) 298 U. S. 513, 531.) It is established that the Federal Government has left the liquidation and winding up of insurance companies to the laws of the several states (*In re Union Guarantee & Mortgage Company, supra*), and under the presumption herein assumed the tax obstructs and restricts the power of the state to protect the public interest in liquidation just as a Federal tax imposed directly on each company applying for a liquidation order would have such effect.

IV.

Petitioner's compensation comes within the terms of the exemption prescribed by Art. 643 of Treasury Reg. 77.

In the concurring opinion of Mr. Justice STONE and Mr. Justice CARDOZO, in *Brush* v. *Commissioner, supra,* they stated that they concurred in the result upon the ground that the petitioner in that case came within the terms of the regulation which for the purpose of the case may be accepted as valid, "its validity not being challenged by counsel for the Government" (p. 374). Even the present regulation (Reg. 94, Art. 116-2) does not preclude the immunity of petitioner's compensation because his salary was received "from the State" (Exhibit Ex. C, R. 12-D). Petitioner's actual pay check came from the New York State Insurance Department and neither the 1932 regulation, which governs petitioner's case, or the recent regulation refer to the method chosen by the State to raise the funds for the compensation of its officers and employees.

Conclusion.

Petitioner's compensation was paid to him for services rendered as an employee of the State of New York engaged in carrying out a proper governmental function and such compensation is not subject to Federal income tax.

It is respectfully submitted that the judgment of the Circuit Court of Appeals should be reversed and petitioner's 1932 tax liability be recomputed by excluding said salary from his taxable net income.

Respectfully submitted,

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